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UNCLAS SECTION 01 OF 03 MONTREAL 000553

SIPDIS

STATE FOR WHA/CAN - PATRICIA NORMAN, EB/TRA - SUSAN PARSON

STATE PASS USTR FOR SAGE CHANDLER

USDOT FOR JEFF SHANE AND SUSAN MCDERMOTT

FAA FOR KRISTA BEREQUIST

TSA FOR SUSAN WILLIAMS

SIPDIS

USDOC FOR 6310/ITA/TD/TM/OFFICE OF AEROSPACE/TLARGAY

E.O. 12958: N/A
TAGS: EAIR ETRD EFIN ECON CA
SUBJECT: Air Canada Bankruptcy and Restructuring

Ref: (A) Ottawa 00385 (Air Canada financial woes)

(B) Ottawa 00612 (Transportation Strategy Aviation)
(C) 2002 Ottawa 2824 (Report suggests liberalization)
(D) 2002 Montreal 1248 (Air Canada going Discount)

¶1. SUMMARY: Air Canada's recent filing for bankruptcy protection follows efforts over the past several months to restructure its operations and lower its costs in order to remain competitive during a difficult time in the airline industry. However, a combination of its own business decisions, the rise of low-cost competitors, and several devastating events beyond its control helped bring the airline to this point. The bankruptcy protection will provide the airline time to develop a long-term strategy that might allow it to compete in a changed market. The Canadian government has indicated a willingness to provide loan guarantees to Air Canada, but there are currently no plans for a cash bailout. END SUMMARY

¶2. On April 1, 2003 Air Canada sought protection under the Companies' Creditors Arrangement Act (CCAA), Canada's equivalent to Chapter 11. Even before the bankruptcy filing, Air Canada had declared a Force Majeur, citing the war in Iraq, in order to find relief from some contractual obligations and to justify the impending layoffs of 3,600 workers, about 10 percent of its total workforce. The Force Majeur declaration prompted a swift negative reaction from many of the airline's unions, which had already agreed to work with the company to save C$650 million annually in labor costs.

¶3. During 2002 Air Canada lost C$428 million, most of that amount in the final quarter. Since 1999, Air Canada has lost C$1.7 billion and is currently losing about C$3 million per day. It has over C$13 billion of accumulated debt, approximately C$8 billion of which resulted from the 1999 acquisition of Canadian Airlines (then its main rival), which was purchased primarily for its profitable Asian routes. Air Canada's pension liability is also C$1.3 billion. It is the third major North American airline to seek protection from its creditors in the past 18 months, after United Airlines and USAIR.

¶4. As recently as 2000, Air Canada carried about 80 percent of Canada's domestic passenger traffic. The company's overwhelmingly dominant market share has led rivals to accuse it of predatory pricing. Predatory or not, the airline's strategies have evidently not been successful: in the last 12 months, Air Canada has lost 12 percent of its domestic market share to its low-cost competitors, principally Calgary-based WestJet. Cameron Doerksen, aerospace analyst for Dlouhy Merchant Group, a Montreal-based investment bank, told post "they [Air Canada] simply cannot compete in the low-cost carrier market with a big airline budget," a view echoed by Michel LeBlanc, CEO of Montreal-based low-cost carrier Jetsgo.

¶5. Over the past two years, Air Canada has tried to compete with its low-cost rivals by dividing its business into the main Air Canada brand and four new subsidiaries and brand names: Zip, Tango, Jazz and Jetz (REFTEL D). Most operate on a lower wage/cost structure, but growth potential is limited by union contracts to a relatively small scale of operation, lest they cannibalize the main Air Canada operations and their higher-wage jobs. Doerksen asserts that despite these efforts to compete in the low-cost market, where it might be difficult for a traditionally high-cost carrier ever to compete effectively, Air Canada will need to focus on its primary strength: long-haul international business travel.

¶6. While Air Canada prepares a restructuring plan, expected in the middle of May, financial services company GE Capital has extended a C$1 billion line of credit to the airline. Air Canada CEO Robert Milton has also called on the Canadian government to provide loan guarantees during the restructuring, claiming it is impossible for Air Canada to compete with U.S.-based carriers that received a large financial package from the U.S. government following the terrorist attacks of September 11, 2001. Transport Minister David Collenette has previously indicated a willingness to consider loan guarantees, but no grants. Meanwhile, the Parliamentary Committee on Airlines recently called for the federal government to assist all Canadian airlines by suspending airport rents and security fee collections for two years. Both LeBlanc of Jetsgo and Clive Bedoe, CEO of WestJet, agree that all domestic airlines are vulnerable to current market conditions and believe that a national bailout should apply to all airlines, not just Air Canada.

¶7. Air Canada returned to Ontario Superior court on April ¶22. In a hearing attended by attorneys from its labor unions and over 100 creditors seeking payment, Air Canada requested an extension of its restructuring window to June 30, permission to delay its annual meeting until a restructuring plan is complete, and approval to renegotiate some of its labor agreements. Air Canada had tentatively been permitted to suspend some of its contractual obligations when it made its CCAA filing on April 1. Unlike U.S. Chapter 11, the CCAA has not historically permitted companies to void collective bargaining agreements. On April 22, Ontario Justice James Farley rescinded some of the protections given Air Canada on April 1, but encouraged the airline and its unions to continue negotiations that would allow Air Canada to produce a viable restructuring plan. Both sides tried to interpret this outcome as a victory; the unions because Justice Farley denied Air Canada's request to bypass its agreements, and Air Canada because it may have obtained more flexibility in dealing with its unions than many companies have in the past. Air Canada's decision to make its CCAA filing in Ontario is believed by some analysts to have been influenced by a recent Quebec court ruling in the case of Quebec mining company Jeffrey Mine, Inc., that collective agreements are protected during a restructuring period.

¶8. In order to raise cash, Air Canada has in recent months attempted to sell some of its key holdings. In February 2003, it sold a 35 percent stake in Aeroplan, the airline's frequent flyer program, for C$245 million, and recently renegotiated an agreement with the Canadian International Bank of Commerce (CIBC) that will allow it to generate cash by selling frequent-flyer miles to retailers and insurance companies. The Jazz subsidiary, a pan-Canadian domestic carrier, has been put up for sale, as has Air Canada Technical Services (ACTS). ACTS may have a potential buyer in La Federation des travailleurs du Quebec (FTQ), which has 2,500 members working at ACTS in Quebec. Andre Viau, portfolio manager for aerospace with the FTQ pension fund management group, told post "the deal is not yet clear. While we have a double interest in saving jobs and making some money, we might be looking to take on a small stake." Selling Jazz may prove more difficult; unlike some of the new subsidiaries, Jazz is burdened with older equipment and high labor costs, making it a relatively unattractive property in a slow airline market. In addition, federal law restricting foreign ownership of Canadian airlines to 25 percent limits the pool of potential buyers. CEO Milton and other industry insiders have called on Transport Minister Collenette to amend this law, but he has stated that it would remain in place until the U.S. makes the same change.

¶9. Air Canada's bankruptcy filing has caused short-term problems for others in the Canadian aviation system. NavCanada, the Crown Corporation that operates the country's air-traffic control system, is in financial jeopardy because Air Canada - its best customer - has failed to make its C$4 million weekly payment since the CCAA filing. Air Canada owes Aroports de Montreal C$11.5 million for unpaid rents and services rendered, and the Greater Toronto Airport Authority has seen its bond ratings lowered by Standard and Poor's in the wake of the Air Canada bankruptcy filing. Justice Farley has denied creditors' statutory right to seize Air Canada's assets until after a restructuring plan is submitted.

¶10. Air Canada is continuing regular operations during its restructuring, and the impact on travelers should be minimal. However, in addition to lingering effects of the September 11 attacks and the war in Iraq, the recent outbreak of SARS is affecting Air Canada especially hard; their most profitable international routes are to Asia, while Toronto serves as its primary Canadian hub. Even before the CDC and the World Health Organization issued travel advisories for Toronto, many people had been avoiding Toronto's Pearson Airport. Taken together, Air Canada is experiencing a drop in passenger traffic at a time it can

little afford it. Air Canada several days ago mentioned that it might look to route some of its international flights to other airports - in particular Halifax and Montreal - but no such plan is yet in place.

¶11. In the longer run, prospects may be more encouraging for both Air Canada and others. Typically, an airline of Air Canada's size will emerge from bankruptcy protection between 20-30 percent smaller, according to Doerkson. Viau believes the new Air Canada will be smaller but stronger. "With a smaller airline, they [Air Canada] will probably look to increase their outsourcing contracts, which will be good for the aerospace sector in Montreal," he told post. Milton recently announced that a restructured Air Canada will have to shape itself along the lines of the new North American airline business model, with smaller planes and lower operating costs. Air Canada has recently joined a consortium to purchase regional jets from Bombardier; Air Canada would initially acquire 25 of these jets to serve short-haul, moneymaking routes. Air Canada recently named former Bombardier CEO Robert Brown to its board, which suggests that Bombardier is likely to remain Air Canada's principal aircraft supplier in this market, as opposed to its primary competitor, Brazil's Embraer.

¶12. Comment: Air Canada's current predicament appears to be the result of both its own decisions in recent years and a number of unfortunate circumstances beyond the company's control. Like many airlines, Air Canada has sought to lower its costs, either through changing union contracts or establishing new business models. These measures have and will likely continue to generate resistance but are probably essential to Air Canada's long-term viability. End Comment.
KANTER